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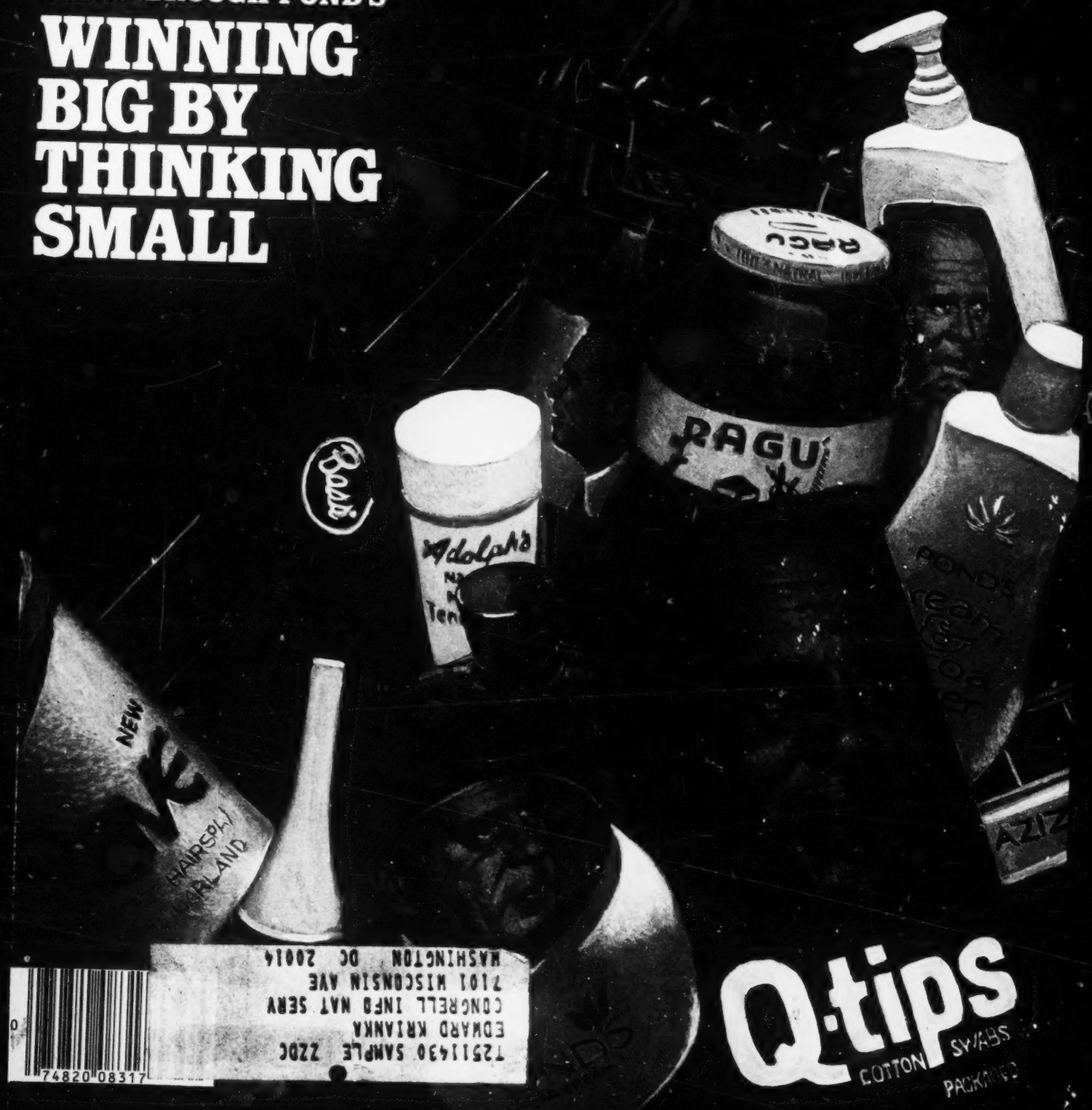
Forbes

RALPH WARD OF CHESEBROUGH-POND'S

WINNING BIG BY THINKING SMALL



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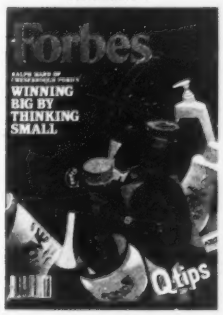

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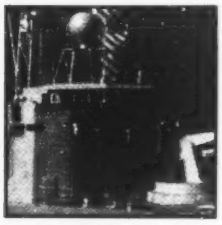

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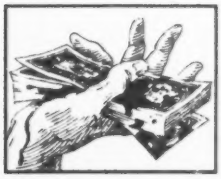

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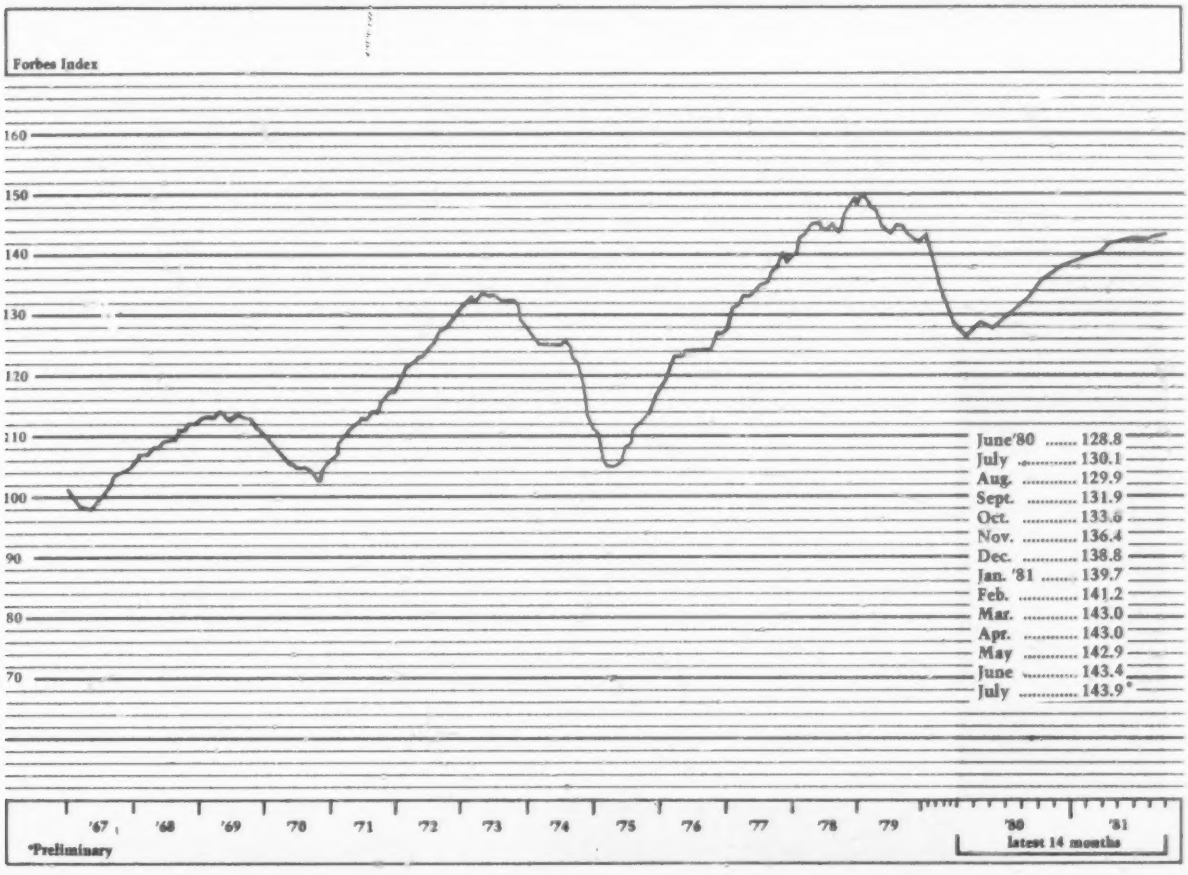
The Forbes Index



The Forbes Index Components

What recession? After minor revisions, the Forbes Index is up more than 0.3% in July. The Index would be even higher were it not for a 3.4% decline in housing starts. Industrial production, manufacturers' new orders, inventories and retail sales are all up. Personal income also increased slightly. Still, high interest rates and the Administration's desire to curb inflation are soon likely to slow the growth of the Index.

The FORBES Index is a measure of U.S. economic activity composed of eight equally weighted elements:

Total industrial production

New claims for unemployment compensation

The cost of services relative to all consumer prices

The level of new orders for durable goods compared with manufacturers' inventories

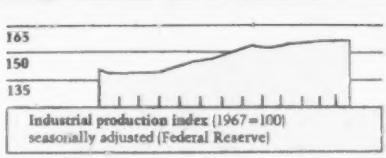
Total retail sales

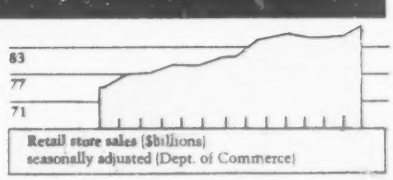
New housing starts

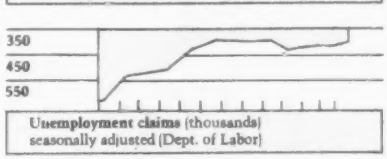
Personal income

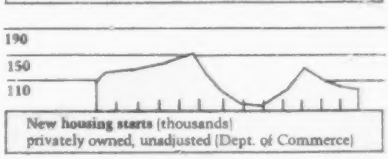
The change in the amount of consumer installment debt outstanding

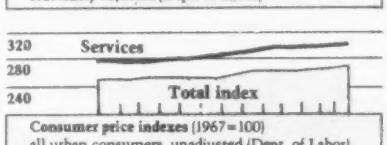
To measure these eight elements, FORBES monitors 11 series of U.S. government data. The last 14 months' data for each series is presented at right.

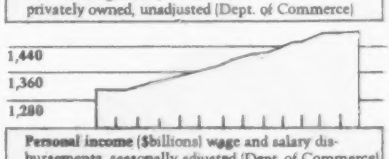


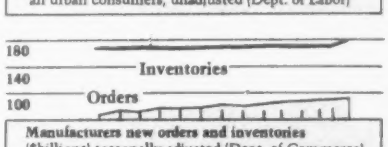


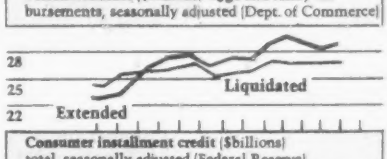




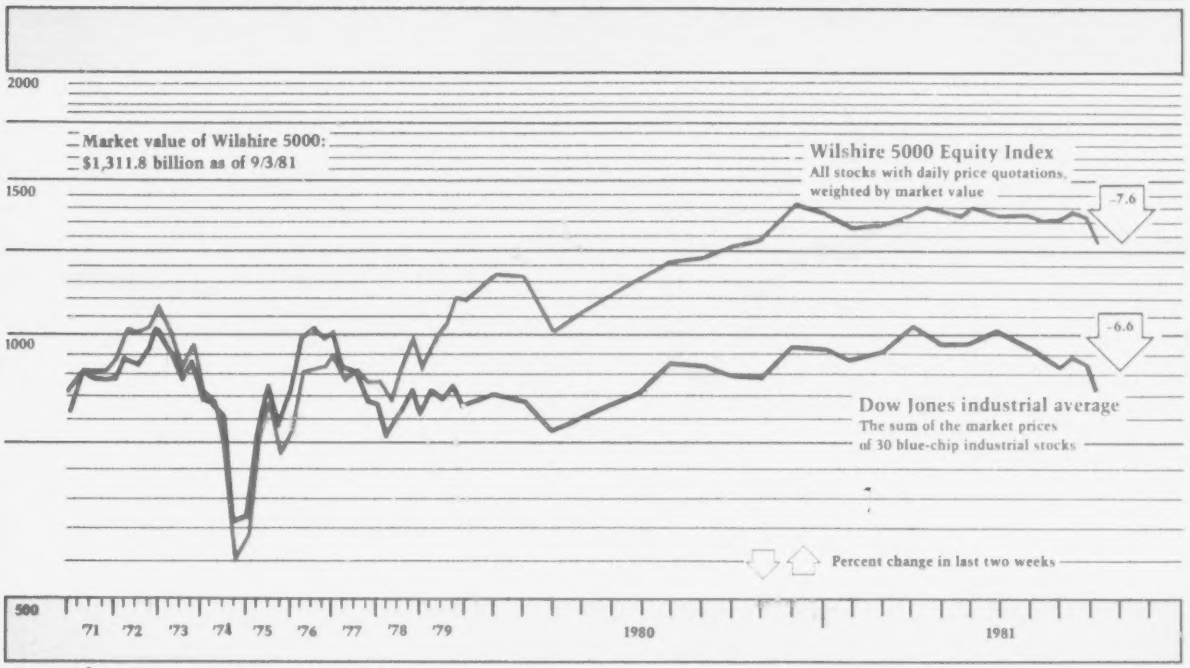








The Forbes/Wilshire 5000 Review



Searching for a bottom. A few feeble attempts to rally have not prevented the market from continuing its downward slide. Major market indicators slumped by 8.6% or more over the last 4 weeks. The NASDAQ stocks were hardest hit. They fell 9.3%. But the broadly based Wilshire isn't too far behind. Its 8.9% reversal also means that Wall Street has given up more than $93 billion in market value in the past month. The Wilshire also shows, however, that the total value of all listed securities for which price quotes are available still exceeds $1.3 trillion.

Any drop below 800 in the Dow is likely to have a negative psychological impact on investors, and the market may actually test this level within the next few weeks. Investors are already leery of a new wave of inflation, which still seems strong. Rates of 14.76% for long-term Treasury bonds are not helping Wall Street.

In its decline the market may be shifting from an overbought to an oversold position. If stocks drop even lower, better bargains will be created. This will eventually set the stage for significant buying opportunities. But perfect timing is nearly impossible. The folks who get the best bargains will no doubt be snapping up equities when the current outlook is bleakest. This time, however, the averages have fallen so steeply that even investors who forego their purchases until they've seen the bottom still stand to score impressive gains.

Close-up On The Equity Markets

Performance of five leading indexes

Percent change	Wilshire 5000	Dow Jones industrials	NYSE Composite	ASE Market Value Index	NASDAQ Composite
in last 4 weeks	–8.9	–9.0	–8.8	–8.7	–9.3
in last 52 weeks	–1.8	–8.6	–3.0	1.9	3.8

Stock performance based on five key investor yardsticks

Percent change	Volatility *		P/E multiple		Dividend yield		Growth profile †		Share price	
	high	low	over 25	under 5	over 7.5%	none	high	low	over $40	under $4
in last 4 weeks	–13.0	–3.0	–12.1	–7.5	–4.4	–10.4	–12.3	–5.8	–8.4	–9.6
in last 52 weeks	5.4	7.9	4.3	6.2	–0.2	10.4	6.0	6.4	–0.7	14.3

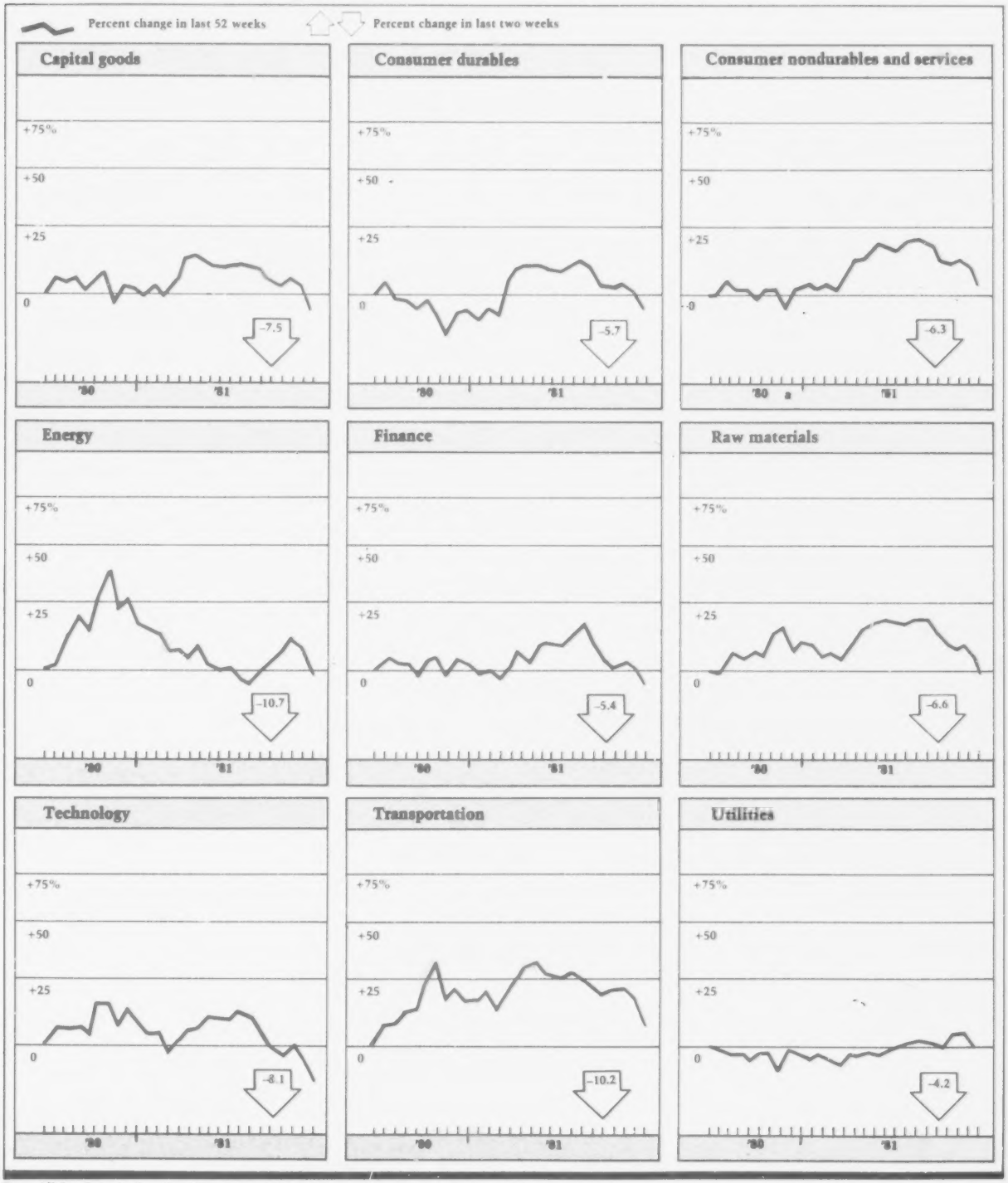
* A stock's sensitivity to overall market movement. High-volatility issues have wide price fluctuations; low-volatility issues are more stable.
† A quantitative evaluation of a stock's growth image, determined by Wilshire Associates.

Note: All data for periods ending 9/3/81. Prepared by Wilshire Associates, Santa Monica, Calif.

Where The Action Is

Even the good news is bad. Even though the utilities declined 4.2%, they still outperformed all other sectors. That was the good news. In the most recent two weeks technology companies have dropped 8.1% and capital goods producers lost 7.5%. The biggest drop was in the energy sector. It declined 10.7%. Oil and gas companies had been pumped up by merger speculation, and it may take another massive acquisition battle to stem their slide. Another big loser was the transportation group, off 10.2%. The skies continue to look gloomy for the airlines, and the prospects of more fare cuts won't help.

This period's steep declines have taken back most of the gains the market made over the past several months. Two weeks ago technology was the only sector to show red ink over a 52-week period. Now 6 of the 9 sectors are in the red. Technology is still hurting the most. It's behind 13%. Still in the black: Consumer nondurables and services, raw materials and transportation.



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Statistical Spotlight

A computerized system, with an emphasis on cash flow, aims to pinpoint stocks that will be poor performers.

Sorting out the losers

By Steve Kichen

TOM NOURSE HAS ALWAYS been a maverick. A graduate of Purdue and chemical engineer by training, he spent much of his career as a marketing man and consultant on business performance. Yet Nourse never lost a scientist's penchant for the truth. "I had firsthand experience seeing managers making decisions on what I felt was misinformation," he explains. "So I started to search for better yardsticks to measure business performance."

Over a decade ago, Nourse quit his job as vice president of Interactive Sciences Corp., a Braintree, Mass.-based time-sharing company, and started to develop his ideas. Cash flow analysis (FORBES, *Feb. 2*) dominates Nourse's approach. His firm, Nourse Associates, publishes a fat volume containing comparative performance analyses of corporate balance sheets and incom statements that Nourse sells as a management tool. Beyond that, however, he doesn't think Wall Street is fooled by today's reported profit gains, which he feels come at the expense of new investment.

To try his hand at picking stocks, Nourse is testing a computer analysis that he calls SOS. That's for Stock Omit Screen, a way to find probable poor performers. Early results are intriguing: Nourse called a 1980 Value Line Special Situations list of 19 stocks and eliminated 10. When the entire group appreciated by 100%, his abbreviated list was up nearly twice as much. Similarly, Nourse evaluated a year-old Kidder, Peabody list of 50 high-P/E stocks and a presentation in a recent FORBES Statistical Spotlight. Both times his screening eliminated losers and boosted performance by 30% or more.

Nourse is testing his system against a new list of stocks, presented here. It is a select group of large companies selling at above-market earnings multiples. His computer rejects 26 of the 44 stocks. The 18 securities that pass the screen are colored yellow in the table.

Nourse begins his evaluation by comparing two different types of cash flow. The first is earnings plus depreciation, just what basic accounting textbooks describe. The second, "actual" cash flow, is a much more conservative figure. It measures aftertax profits minus everything that a company buys. Incremental investment in plant, equipment, inventory and receivables is subtracted from aftertax earnings; so Nourse really winds up with a measure of cash actually generated by the business rather than by accountants.

"Anyone running a business on a cash basis rather than an accrual basis knows that this is the way to measure the health of a company," he explains. Nourse's actual cash flow comes to only 0.3% of sales for the more than 1,000 companies in his data base—to him an indication that the current growth of corporate profits is largely an illusion.

A stricter interpretation of cash flow, however, is only part of Nourse's Comparative Business Performance Reports System. Another important element is what he calls the Performance Factor. This statistic is a combination of sales growth, quality of earnings, cash flow to funds requirement and investment expansion. Each year it is calculated to equal 1.0 for the 1,000-company data base.

At a quick glance, Nourse can tell that SmithKline, for example, with a performance factor of 5.78, is strongly beating the industrial aggregate. And it is also ahead of the drug industry's 1.79. Food services and basic chemicals, with performance factors of 0.74 and 0.77, are groups that are underperforming industry as a whole.

Tom Nourse started massaging his data on a programmable calculator, but his San Diego office is now equipped with a Radio Shack and a Digital Equipment computer. For comparative performance analysis, Nourse distills his data on each company into a four-position grid, something any chemist can appreciate. The strategic positions: Invest, Protect, Maintain and Review.

A high-growth company is almost always in his "Invest" position. An Invest company has outstanding sales and stock performance and generally above-average profit performance as well. It also has the highest level of reinvestment and the second-highest degree of leverage. Wang Labs, Hewlett-Packard, Amdahl and Time Inc. are notable examples.

There are drawbacks to the Invest position, however. Nourse's conservative actual cash flow measurement shows that Invest companies have negative cash flow. But as long as investment and performance stay high, this tradeoff is usually acceptable. A company can quickly find itself in trouble if its performance factor deteriorates. From 1980 to 1981, for example, Data General went from Invest to Review. The stock plummeted 48% over the past 52 weeks.

Protect companies are perhaps the best in Nourse's scheme of things. Merck and General Electric, for example, aren't reinvesting as intensely as Invest companies. But on the other hand they are not as leveraged and their cash flow is positive.

Maintain is a less desirable position. Nourse looks at Maintain companies such as Mead, TRW and Westinghouse as firms that are treading water to stay alive. They are reinvesting enough and showing enough actual cash flow to hold their own, but not much more. In his capacity as a consultant, the advice Nourse gives to Maintain companies is to embark on new ventures and acquisitions but only after a company has its existing operations well under control.

The least desirable strategic position is Review. These companies are using cash but not reinvesting at a suitable level, and they are highly lev-

eraged. Nourse offers strong medicine. "No new products, no new markets, no new territories and no new investments. Give up your dreams and go for cash flow and liquidity." That's why Nourse is not keen on Allied Corp., one of his Review companies. He would rather see it trimming fat instead of making acquisitions. Nourse doesn't like Humana either. "While I realize it has been a superb stock performer, it will not pass the screen because of its strategic position in Review and negative actual cash flow," warns Nourse. But if Nourse is right, Dana Corp., an Invest company, should be among the best performers of the 44 stocks that accompany this feature.

Tom Nourse is yet another analyst out to test the efficient market theory. Can a renegade scientist succeed where so many others have failed? Keep watching.

The big test

Below, 44 securities selling at earnings multiples much higher than the market. According to Tom Nourse, publisher of Comparative Business Performance Reports, only 18 stocks will show superior performance: These issues are highlighted in yellow. Nourse's CBPR model favors companies that his computer slots as Invest or Protect positions; less desirable holdings are labeled Maintain and Review.

Company/principal business	Revenues (millions)	Recent price	Latest 12-month EPS	Latest 12-month P/E ratio	Yield	Book value per share	Strategic position
General Motors/automotive	$57,728.5	46¼	$0.61	76.0	5.2%	$61.49	maintain
Coastal Corp/oil	5,115.4	49⅝	0.98	50.6	0.8	22.47	review
Fleetwood Enterprises/manufactured homes	427.6	10	0.22	45.5	5.2	9.56	protect
Pittston/coal, oil, armored cars	2,051.6	25¼	0.57	44.3	4.8	17.73	protect
General Host/food processing	424.7	18½	0.46	40.2	4.9	11.81	invest
North American Coal/coal	439.6	33¾	0.85	39.7	2.1	24.55	invest
MacMillan Inc/publishing	566.0	15¼	0.50	30.5	3.3	11.14	maintain
Akzona/chemicals	1,054.0	11⅞	0.46	25.8	6.7	27.18	review
Amdahl/computer equipment	394.4	30⅝	1.30	23.6	1.3	14.42	invest
M/A-Com/telecomm equipment	322.5	23⅛	0.99	23.4	0.5	4.29	invest
Wang Laboratories/computer equipment	856.4	29	1.36	21.3	0.4	3.76	invest
Ashland Oil/refining	8,118.4	38⅞	1.87	20.8	6.2	34.66	maintain
Dana/auto parts	2,524.0	25¼	1.26	20.0	6.3	24.48	invest
Echlin Manufacturing/auto parts	301.4	11⅝	0.58	20.0	4.5	8.84	invest
Federal Express/package delivery	589.5	57⅞	2.89	20.0	—	9.41	review
Dow Jones & Co/publishing	530.7	44¼	2.23	19.8	2.1	5.18	protect
Texas Oil & Gas/oil & gas	1,190.8	36¼	1.87	19.7	0.7	2.72	review
Wal-Mart Stores/retail	1,643.2	35⅝	1.83	19.5	0.7	7.68	invest
Waste Management/waste disposal	560.2	33	1.70	19.4	1.2	6.69	review
SEDCO/oilfield services	372.9	29⅛	1.52	19.2	1.0	10.68	invest
Hospital Corp of America/health care services	1,428.5	37¼	1.99	18.7	0.9	9.70	invest
Empire Inc/distributes LP-gas	357.7	19¾	1.07	18.5	2.0	10.57	maintain
E-Systems/electronics	442.2	44¼	2.42	18.3	2.3	20.00	invest
Tandy Corp/retail electronics	1,691.4	29⅞	1.65	18.1	—	3.12	protect
Hewlett-Packard/precision instruments	3,099.0	43½	2.44	17.8	0.6	12.85	invest
Automatic Data Processing/computer services	558.4	26¾	1.51	17.7	1.6	5.13	invest
Electronic Data Systems/computer services	454.6	24¼	1.39	17.4	2.5	5.17	maintain
EG&G Inc/precision instruments	613.1	36	2.09	17.2	1.4	7.93	maintain
Masonite/building materials	510.6	36⅜	2.13	17.1	3.6	19.68	maintain
Weyerhaeuser/forest products	4,535.8	30⅞	1.83	16.9	4.2	20.96	maintain
Beckman Instruments/precision instruments	618.1	29⅝	1.76	16.8	1.2	13.56	invest
Mesa Petroleum/oil & gas explor & dev	372.4	24⅞	1.52	16.4	0.5	7.59	review
Storage Technology/computer equipment	603.5	31½	1.94	16.2	—	9.07	invest
Humana/health care services	1,116.8	33	2.09	15.8	1.8	4.23	review
Warner Communic/entertainment, comm	2,059.4	43¾	2.78	15.7	1.6	12.55	maintain
Dun & Bradstreet/publishing	1,176.1	62	3.97	15.6	3.8	7.51	protect
American Bakeries/food processing	535.6	15½	1.00	15.5	—	22.14	invest
Advanced Micro-Devices/electronics	309.4	18⅜	1.21	15.2	—	7.70	invest
Western Co of North America/oilfield services	457.5	27	1.79	15.1	0.7	5.73	invest
Oak Industries/CATV, electronics	385.6	29¾	1.99	14.9	0.8	12.33	invest
Geosource/oilfield products & services	441.3	52	3.51	14.8	1.0	11.74	invest
First Mississippi/chemicals, oil & gas	357.7	20¼	1.38	14.7	1.2	5.28	protect
Cox Broadcasting/broadcasting, CATV, pub	309.2	64¾	4.47	14.5	0.8	12.98	invest
Time Inc/publishing, forest products	2,881.8	72⅞	5.08	14.3	2.7	31.84	invest

Sources: Nourse Associates, Standard & Poor's.